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VIA COURIER

EX PARTE

FILED/ACCEPTED

DEC – 7 2006

Federal Communications Commission
Office of the Secretary

December 7, 2006

Ms. Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, DC 20554

Re: *In the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112; *In the Matter of 2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules*, CC Docket No. 00-175; and *In the Matter of Petition of Qwest Communications International Inc. for Forbearance from Enforcement of the Commission's Dominant Carrier Rules As They Apply After Section 272 Sunset Pursuant To 47 U.S.C. § 160*, WC Docket No. 05-333

Dear Ms. Dortch:

On July 26, 2006 and in a subsequent meeting on September 27, 2006, Qwest Communications International Inc.'s ("Qwest") representatives met with Federal Communications Commission ("Commission") Staff to discuss issues arising in the above-captioned Section 272 Sunset proceeding and Qwest's petition requesting that the Commission forbear from regulating Qwest as a dominant carrier in the provision of in-region interstate interexchange services ("in-region-IXC services")[1] post-sunset of Section 272 requirements, whether these services are provided by Qwest Corporation ("QC"), Qwest's incumbent local exchange carrier ("ILEC"), on an integrated basis or separately through some other Qwest

[1] This *ex parte* presentation uses the term "in-region IXC services" to refer generally to all Qwest interexchange services that may originate in a Qwest state and terminate at a location either in another state or outside the United States and the term "IXC services" refers generally to all interexchange services that may originate in any state and terminate at a location either in another state or outside the United States.

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affiliate that is not complying with the full array of the Commission's Section 272 rules in existence prior to sunset ("non-Section 272 affiliate").[2] In our meeting we stated that no additional safeguards would be necessary to guard against cross-subsidization, predatory price squeezes, unreasonable discrimination, and other anti-competitive conduct if the Commission granted Qwest's petition and briefly discussed the accounting treatment of in-region IXC services. The purpose of this letter is to provide additional detail on Qwest's position on these issues and to reiterate positions taken by Qwest in prior comments in the Section 272 Sunset proceeding.[3]

The Commission has previously found that no additional safeguards were necessary to address these issues in order for Qwest to receive its present non-dominant carrier status in the provision of in-region interLATA services through Section 272 affiliates. Qwest demonstrates, in this filing and its prior filings on this subject, that no additional safeguards are needed to address these issues if Qwest were permitted to offer in-region IXC services as a non-dominant carrier on an integrated basis or through a non-Section 272 affiliate. In the *LEC Classification Order*, the Commission concluded that a Bell Operating Company ("BOC") would be regulated as a non-dominant carrier as long as it provided in-region interLATA services through a Section 272 affiliate. The record in this proceeding shows that Qwest's provision of those services should continue to be regulated on a non-dominant basis when it is no longer required to maintain a Section 272 affiliate. As discussed below, the same findings that led the Commission to conclude that adequate safeguards existed if Qwest were categorized, pre-sunset, as a non-dominant provider (*e.g.*, lack of ability to raise prices by restricting output, the needless cost of imposing tariff and price cap requirements and other dominant carrier regulation, the lack of any connection between perceived dangers such as improper cost allocation and dominant carrier regulation, and, perhaps most importantly, the continued presence of statutory and regulatory safeguards such as those contained in Section 272(e) of the Act) still apply in the event Qwest is categorized as a non-dominant provider of in-region IXC services post-sunset.[4]

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[2] *See* Petition for Forbearance of Qwest, filed on Nov. 22, 2005 (corrected version of Petition filed on Nov. 30, 2005) ("Qwest Nov. 22, 2005 Petition").

[3] Qwest Comments, WC Docket No. 02-112 & CC Docket No. 00-175, June 30, 2003; Qwest Reply Comments, WC Docket No. 02-112 & CC Docket No. 00-175, July 28, 2003. The Declaration and Reply Declaration of Dennis W. Carlton, Hal Sider and Allan Shampine, WC Docket No. 02-112 and CC Docket No. 00-175, filed June 30, 2003 and July 28, 2003, respectively, in the Section 272 Sunset proceeding are attached for ease of reference.

[4] In fact, the language of the *LEC Classification Order* makes it clear that the Commission did not believe that subjecting Section 272 separate affiliates to dominant carrier regulation would provide any additional protection against unlawful price squeezes, improper cost allocations or unlawful discrimination. In finding that BOC Section 272 affiliates should be classified as non-dominant providers, the Commission "also conclude[d] that regulating BOC in-region interLATA affiliates as dominant carriers generally would not help to prevent improper allocations of costs, discrimination by the BOCs against rivals of their interLATA affiliates, or price squeezes by the BOCs or the BOC interLATA affiliates." *See In the Matter of Regulatory*

Price Squeeze

Opponents of post-sunset relief for Qwest from dominant carrier regulation contend that Qwest will subject IXC competitors to an illegal predatory price squeeze by increasing wholesale rates (*i.e.*, switched and special access rates) while decreasing retail rates (*i.e.*, in-region IXC services). Thus, they claim that Qwest will sacrifice long distance revenue today in order to drive competitors out of the market with a goal of recouping lost profits (or losses) through higher retail long distance prices in the future. Opponents' allegation is not supported by either the facts or economic theory.

In their declaration appended to Qwest's reply comments in the Section 272 Sunset proceeding, Drs. Carlton, Sider and Shampine point out that even if the BOCs were able to raise access prices post-sunset, it is unlikely that they could successfully engage in a predatory price squeeze in the long distance market because: 1) BOCs face numerous well-established wireline and wireless long distance providers; 2) communications assets are largely fixed and will remain available to new entrants at low prices even if existing competitors are driven from the market; 3) any attempt by the BOCs to raise prices in such an environment would invite new entry; and 4) if BOCs were successful in eliminating long distance competition through predatory pricing they, inevitably, would be subject to re-regulation.[5] Drs. Carlton, *et al.*, conclude that it is highly unlikely that a BOC could recoup its investment in predatory pricing and highly unlikely that such a strategy would be pursued by a BOC.[6]

Drs. Carlton, *et al.*, reject the allegation that above-cost access charges provide BOCs with both the incentive and the ability to engage in a price squeeze. They point out that not only do higher access charges result in higher costs to all long distance carriers, higher access charges also represent higher opportunity costs for BOCs when the BOCs win long distance business from other IXCs. "That is, when ILECs [BOCs] provide long-distance service they gain retail revenue but lose access revenue paid by a subscriber's prior long-distance carrier. The loss in access revenue is a real cost of providing retail long-distance service faced by ILECs which must

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Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interexchange Marketplace, Second Report and Order in CC Docket No. 96-149 and Third Report and Order in CC Docket No. 96-61, 12 FCC Rcd 15756, 15762-63 ¶ 6 (1997) ("*LEC Classification Order*") (subsequent history omitted).

[5] Reply Declaration of Dennis W. Carlton, Hal Sider and Allan Shampine, WC Docket No. 02-112 and CC Docket No. 00-175, filed July 28, 2003 at 7-10 ("Carlton Reply Declaration") (attached hereto).

[6] The Court of Appeals recognized this in affirming the *Pricing Flexibility Order*, "there is a consensus among commentators that predatory pricing schemes are rarely tried, and even more rarely successful." *WorldCom, Inc. v. FCC*, 238 F.3d 449, 463 (D.C. Cir. 2001).

be considered in any evaluation of the prices charged by ILECs as long-distance carriers."[7] Drs. Carlton, *et al.*, go on to provide a numerical example demonstrating that BOCs "have no incentive to lower long-distance prices below the long-run competitive level (i.e., the level at which revenues cover relevant costs) and drive more efficient rivals from the industry in order to provide long-distance themselves."[8] Thus, contrary to the claims of opponents, above-cost access charges -- even if they were true -- do not facilitate predation.

Drs. Kahn and Taylor came to similar conclusions in dismissing AT&T's special access price squeeze arguments that were contained in AT&T's petition seeking repeal of the Commission's *Pricing Flexibility Order*:[9]

> The flaws in AT&T's reasoning are well-recognized. First, pricing special access services above cost can not impair competition in the long distance market because the RBOC long distance affiliates buy special access under the same tariffs and OPPs [optional pricing plans] as AT&T [as required by Section 272(e)(3)]. Therefore, pricing special access above cost can not generate a differential advantage for the RBOC's own long distance service or impose an anticompetitive price squeeze on an IXC... Special access charge revenue (when AT&T supplies the retail service) is revenue that the RBOC foregoes when it supplies the retail customer itself. The higher that access revenue, the higher the retail price the RBOC long distance affiliate would have to charge to make long distance service profitable for the RBOC as a whole, as well as to make long distance service profitable on the books of its long distance affiliate... The RBOC affiliate's retail price reflects to the penny what IXCs pay for access, as is required by both the law and by economic self-interest.[10]

[7] Carlton Reply Declaration at 4 (attached hereto).

[8] *Id.* at 6.

[9] The Commission subsequently opened a rulemaking proceeding to address the issue of how special access, provided by price cap local exchange carriers ("LECs"), should be regulated after the expiration of the CALLS plan including whether the Commission's pricing flexibility rules for special access should be modified or maintained. The Commission has not yet taken any action in this proceeding. *See In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, Order and Notice of Proposed Rulemaking, 20 FCC Rcd 1994 (2005).

[10] *See* Declaration of Alfred E. Kahn and William E. Taylor, *In the Matter of AT&T Corp. Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services*, RM No. 10593, Qwest Opposition, Kahn and Taylor Declaration at 34, filed Dec. 2, 2002 (footnotes omitted). Kahn and Taylor's argument is equally relevant for BOCs providing in-region IXC services on an integrated basis since Section 272(e)(3) requires BOCs to impute access charges to themselves in such a situation.

Earlier, in adopting the *LEC Classification Order*, the Commission rejected similar claims finding that the BOCs and their affiliates would not be able "to engage in a price squeeze to such an extent that the BOC interLATA affiliates will have the ability, upon entry or soon thereafter, to raise price by restricting their own output."[11] The Commission also found that even if the BOCs could subject IXCs to a price squeeze -- which they cannot -- imposing dominant carrier regulation on BOC long distance affiliates would not be an efficient means of preventing BOCs from engaging in a predatory price squeeze.[12] The same reasoning holds true with regard to Qwest's provision of in-region IXC services on an integrated basis or through non-Section 272 compliant affiliates after sunset of the Section 272 separate affiliate requirements. Both Qwest's incumbent local exchange carrier ("ILEC") and non-Section 272 affiliates will continue to be subject to the non-discrimination provisions of Section 272(e) after sunset. Moreover, Qwest's ILEC affiliate will continue to be subject to dominant carrier regulation in the provision of exchange access services (which are provided under tariff). As such, there is little, if any, possibility that Qwest could subject competitors to an unlawful price squeeze if Qwest's petition were granted.

<u>Cross-Subsidization or Improper Cost Allocation</u>

One of the most common cries of competitors whenever Qwest requests regulatory relief is the allegation that Qwest will cross-subsidize its competitive services by improperly allocating costs to regulated services. Qwest's opponents usually propose definitions of "cross-subsidization" that are self-serving and at odds with conventional economic wisdom regarding cost allocation.[13] They ignore the fact that the "cross-subsidization" of competitive services by regulated services as described by Qwest's competitors cannot occur except in a rate-of-return environment where the prices of regulated services are based on assigned costs. Such a regulatory environment no longer exists at the federal level for Qwest and other price cap companies.

[11] *LEC Classification Order*, 12 FCC Rcd at 15832 ¶ 129.

[12] *Id.* at 15831-32 ¶ 128.

[13] Economists normally define cross-subsidization as "the support of a service priced below its marginal cost by another service priced above its marginal cost." *See Competition and Cross-subsidization in the Telephone Industry*, by Leland L. Johnson, December 1982, The Rand Corporation, at iii. *Also see*, *In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, Third Report and Order, and Order on Reconsideration of the Second Report and Order, 14 FCC Rcd 2545, 2566 ¶ 45 and n.81 (1999). In commenting on the fact that "there is no single correct method for allocating common costs among regulated services," the Commission noted that "[a]s long as each type of call recovers its incremental costs, but no more than its stand-alone costs, there is no cross-subsidy." Qwest agrees with the Commission's definition of cross-subsidization.

Neither interstate access charges nor in-region IXC service prices are subject to rate-of-return regulation. Access charges are based on price cap regulation while in-region IXC service prices are determined by the market. In the *LEC Classification Order* the Commission found that "price cap regulation of the BOCs' access services reduces the BOCs' incentives to allocate improperly the costs of their affiliates' interLATA services" because price cap regulation severs the link between regulated costs and rates.[14] In-region IXC service prices are unaffected by how many or how few costs are assigned to them since these prices are determined by the market. Furthermore, Qwest will continue to be subject to the non-discriminatory provisions of Section 272(e) after sunset. As such, there is no basis for post-sunset cross-subsidization claims -- regardless of how cross-subsidization is defined.

Discrimination

The Communications Act of 1934, as amended, ("Act") and the Commission's implementing regulations already contain numerous prohibitions against unlawful discrimination by Qwest. Consequently, no further safeguards are needed as a predicate to the grant of Qwest's forbearance petition. First and foremost, Section 272(e) will remain in place after sunset and it prohibits discrimination in the pricing and provisioning of telephone exchange and exchange access services.[15]

Section 272(e)(1) requires that Qwest's BOC fulfill requests for telephone exchange and exchange access services for unaffiliated entities at least as fast as it provides such service to itself or its affiliates. Section 272(e)(2) prohibits Qwest's BOC from providing any "facilities, services or information concerning its provision of exchange access" to an affiliate providing in-region IXC services unless such facilities, services or information is made available to IXC competitors on the same terms and conditions. Section 272(e)(3) requires Qwest's BOC to charge its affiliates (or impute to itself) at least as much for telephone exchange service and exchange access service as it charges unaffiliated IXCs. Lastly, Section 272(e)(4) requires that Qwest's BOC make available all services and facilities that it provides to its interLATA affiliate on the same terms and conditions.

In addition, Section 252(c)(5)'s network disclosure rules ensure that competitors will not be disadvantaged in planning and provisioning in-region IXC services.

Bundling/Tying

[14] *LEC Classification Order*, 12 FCC Rcd at 15817-18 ¶ 106.

[15] 47 U.S.C. § 272(e). *Also see* the *Non-Accounting Safeguards Order*, where the Commission found that sub-Sections 272(e)(2) and (e)(4) would remain in effect after sunset. *In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended*, First Report and Order and Further Notice of Proposed Rulemaking, 11 FCC Rcd 21905, 22035-36 ¶ 270 (1996).

Another concern that opponents have voiced in opposing Qwest's petition is that competitors will be harmed by Qwest's bundling of local exchange and long distance services. They argue that bundled service packages offered by Qwest should be subjected to dominant carrier regulation. The Commission should reject this suggestion as a transparent, self-serving attempt to hamper Qwest's ability to compete effectively to serve residential and business customers in its region.

Permitting Qwest to offer bundled local and long distance service packages does not raise any anti-competitive concerns. Bundling has been very popular among both Qwest's competitors and its customers. Bundling does not increase the risk that Qwest will engage in anti-competitive conduct. Regulated services, such as local exchange service, are available to all customers separately on a stand-alone and non-discriminatory basis. Currently, Qwest offers different packages of interstate long distance and local exchange service at a single price. Qwest's ILEC provides the local service portion of these packages at tariffed rates while Qwest's Section 272 affiliate, provides interstate long distance service (which is not tariffed) and bears the cost of any discounts associated with these service bundles. There is no need to place any additional restraints on Qwest's provision of bundled service packages after a grant of its forbearance petition.

In allowing ILECs to bundle regulated transmission services with customer provided equipment ("CPE") and enhanced services, the Commission found that the ability of ILECs to engage in anti-competitive cross-subsidization is minimized by state requirements that local exchange service be available at unbundled tariffed rates and the Commission's price cap and accounting rules.[16] The same logic holds true for bundling interstate long distance services and local exchange service.

The risk of Qwest engaging in anti-competitive conduct as a result of bundling long distance and local exchange services is quite low and is out-weighed by the consumer benefits of bundling. In the *CPE Bundling Order*, in permitting ILECs to bundle CPE, enhanced services and local exchange service at a single price, the Commission found the risk of anti-competitive behavior to be low "not only because of the economic difficulty that even dominant carriers face in attempting to link forcibly the purchase of one component to another but also because of the safeguards that currently exist to protect against this behavior" including state requirements that local exchange service be offered on an unbundled basis and the Commission's requirement that exchange access and other dominant carrier services be provided separately on a nondiscriminatory basis.[17] The same is true with respect to bundling local exchange service and

[16] *See In the Matter of Policy and Rules Concerning the Interstate, Interexchange Marketplace, Implementation of Section 254(g) of the Communications Act of 1934, as amended, 1998 Biennial Regulatory Review – Review of Customer Premises Equipment And Enhanced Services Unbundling Rules In the Interexchange, Exchange Access And Local Exchange Markets*, Report and Order, 16 FCC Rcd 7418, 7438-41 ¶¶ 33-38, 7444-45 ¶ 45 (2001) ("*CPE Bundling Order*"); *also see LEC Classification Order*, 12 FCC Rcd at 15817-18 ¶ 106.

[17] *CPE Unbundling* Order, 16 FCC Rcd at 7428 ¶ 12.

in-region IXC services. Prohibiting Qwest from bundling interstate long distance services and local exchange services after Section 272 sunset or regulating such bundles (when provided by Qwest) would harm consumers and give Qwest's competitors an unfair competitive advantage.

Regulating the price of in-region IXC services when it is part of a Qwest service bundle makes no sense since such IXC services are a highly competitive product and Qwest does not have market power in providing it. Similarly, subjecting Qwest's offering of bundled packages to dominant carrier regulation, as some opponents suggest, would confer a substantial and unwarranted competitive advantage on Qwest's rivals and disserve the interests of consumers. The Commission should reject these self-serving proposals.

<u>Accounting</u>

It is Qwest's belief that, in accordance with Section 32.23 of the Commission's rules, in-region IXC services should be accounted for as regulated services when such services are provided on an integrated basis by Qwest's LEC.[18] The benefits of classifying these services as regulated for accounting purposes far outweigh the costs of treating them as nonregulated and subjecting them to Part 64 cost allocations.[19]

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[18] Section 32.23 directs carriers to classify services as regulated if the services have been deregulated at the interstate level but the Commission has not preemptively deregulated similar state services. *See* 47 C.F.R. § 32.23(a). Qwest recognizes that if in-region IXC services were classified as regulated for accounting purposes, some parties might ask the Commission to impose additional cost allocation/tracking requirements on the grounds that such requirements are needed to avoid possible Universal Service Fund ("USF") and state ratemaking problems. Neither suggestion has merit. Qwest's federal universal service support is determined through the use of a computer model that estimates the forward-looking cost of providing service in each wire center. In other words, Qwest's USF is not based on its historical costs of providing service. Further, because most of Qwest's states have adopted price cap mechanisms, allocated costs have little, if any, affect on rates in these states. In the remaining states with rate-of-return regulation, the state commissions have adequate safeguards in place to address any such concerns.

[19] In deregulating LEC broadband services, the Commission found that the adoption of price cap regulation had reduced LECs' incentives to overstate the costs of tariffed telecommunications services and that classifying broadband Internet access services as nonregulated services subject to Part 64 cost allocations imposed significant burdens on LECs with few potential benefits. The Commission also found that in accordance with Section 32.23 of its accounting rules that it was appropriate to classify broadband Internet access services as regulated services. *See In the Matters of Appropriate Framework for Broadband Access to the Internet over Wireline Facilities, Universal Service Obligations of Broadband Providers, Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services, Computer III Further Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review – Review of Computer III and ONA Safeguards and Requirements, Conditional Petition of the Verizon Telephone Companies for Forbearance Under 47 U.S.C.*

On the other hand, if the Commission decides that Qwest's in-region IXC services should be treated as nonregulated, then Qwest would be required to allocate in-region IXC costs in accordance with Part 64. Compliance with this requirement obviously would impose additional costs on Qwest that its competitors would not have to bear.[20] If, however, the Commission were to adopt this approach, Qwest would plan to comply with the requirements of Part 64 in the following manner:

- First, Qwest would impute access charges to its in-region IXC services as is required by Section 272(e)(3) of the Act.[21] By imputing access charges, Qwest would be applying a tariffed rate as required by Section 64.901(b)(1)[22] and covering all costs associated with the use of Qwest's in-region local distribution network, including all local switching and outside plant costs.

- Second, IXC plant in-region investment would be directly assigned in accordance with Section 64.901(b)(2) of the Commission's rules. There would be no cost allocation associated with switching investment because Qwest's in-region Section 272 affiliate operates stand-alone switches used solely for in-region IXC services. As such, Part 64's requirements for assigning central office equipment ("COE") and OSP outside plant ("OSP") investment on the basis of relative use (*i.e.*, using a three-year peak use forecast) would not apply.

- Third, other common costs would be assigned between in-region IXC services and regulated activities using allocators developed in accordance with Section 64.901(b)(3).[23] This would include the assignment of technician time (for technicians performing both regulated and nonregulated activities) using Qwest's existing time reporting system that employs statistical sampling to allocate time between regulated and nonregulated activities.

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§ 160(c) with Regard to Broadband Services Provided Via Fiber to the Premises; Petition of the Verizon Telephone Companies for Declaratory Ruling or, Alternatively, for Interim Waiver with Regard to Broadband Services Provided Via Fiber to the Premises, Consumer Protection in the Broadband Era, Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 14853, 14924-26 ¶¶ 129-35 (2005) ("*Broadband Order*"), *pets. for review pending, Time Warner v. FCC*, Case No. 05-4769 (3rd Cir.). Qwest believes that the same logic should apply to classifying in-region IXC services for accounting purposes.

[20] Competitive local exchange carriers, IXCs and Voice over Internet Protocol ("VoIP") providers are not required to allocate or separate their costs.

[21] 47 U.S.C. § 272(e)(3).

[22] 47 C.F.R. § 64.901(b)(1).

[23] 47 C.F.R. § 64.901(b)(3).

As noted above, because Qwest does not currently maintain any COE or OSP that is used jointly for in-region IXC services and in-region local exchange or exchange access services, treating its in-region IXC services as non-regulated would not require Qwest to allocate the costs of such investment on the basis of a three-year peak use estimate.[24] In the near future, however, as telecommunications plant investment becomes integrated, the Commission will need to revise its Part 64 rules to accommodate new switching technologies and other technological changes.[25] If the Part 64 rules are not simplified to recognize that price cap regulation has replaced rate-of-return regulation and to accommodate the continued evolution of multi-functional COE and OSP investment, Qwest would be unable to deploy the most efficient technology in its network without subjecting itself to unnecessary, inaccurate and very burdensome cost allocations.[26]

While it theoretically would be possible for Qwest to continue to provide in-region IXC services out of Qwest's ILEC affiliate on a going-forward basis without integrating COE and OSP investment, it would not make economic sense to do so. The three-year peak use rule, however, currently presents a substantial deterrent to the deployment of equipment that can be used to provide multiple services. This rule must be significantly modified to accommodate multi-functional COE and OSP investment and to avoid unnecessary duplicative investments.

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[24] 47 C.F.R. § 64.901(b)(4).

[25] Under Part 64, LECs are required to assign COE and OSP investment costs between regulated and nonregulated activities based on forecasts of peak relative use (*i.e.*, the three-year peak use rule, 47 C.F.R. Section 64.901(b)(4)). This rule forces LECs to assign costs based on forecasts of peak relative usage over a three-year forward-looking period. LECs are required to track actual usage and compare it to forecasted usage and are penalized if they have under-forecasted non-regulated usage. In addition, in order to protect ratepayers from the risk of nonregulated business activities (*i.e.*, under rate-of-return regulation), the Commission prohibited reductions in nonregulated investment allocations (*i.e.*, over-forecasts) absent a waiver. *See In the Matter of Separation of costs of regulated telephone service from costs of nonregulated activities, Amendment of Part 31, the Uniform System of Accounts for Class A and Class B Telephone Companies to provide for nonregulated activities and to provide for transactions between telephone companies and their affiliates*, Report and Order, 12 FCC Rcd 1298, 1320 ¶ 169 (1987), *on recon.*, 2 FCC Rcd 6283, 6290-91 ¶¶ 64-70 (1987), *modified on further recon.*, 3 FCC Rcd 6701 (1988), *aff'd sub nom. Southwestern Bell Corp. v. FCC*, 896 F.2d 1378 (D.C. Cir. 1990).

[26] Part 64 is less burdensome in a circuit-switched environment where a single transmission path is dedicated to one customer for the duration of a call. If in-region IXC service is classified as a nonregulated activity and provided on an integrated basis by Qwest's LEC, initially, Qwest would have to separate stand-alone in-region IXC plant investment. In such circumstances, Part 64 would be applied differently than it would in cases where COE and OSP investment is jointly-used and integrated. In the future, assigning costs under the three-year peak use rule will become more problematic and arbitrary as COE and OSP investment becomes more integrated and there is even less agreement among interested parties as to how usage should be measured since many functions may be performed simultaneously.

The three-year peak use forecast rule has long out-lived any usefulness that it may have ever had. It was adopted under rate-of-return regulation in an attempt to ensure that regulated ratepayers would not bear any of the risk associated with a LEC's nonregulated activities and that a significant share of the benefits of integration would accrue to the regulated side of the business. It provides no protection under price cap regulation and is no longer relevant.[27] Rather than encouraging LECs to provide services in the most economic manner, it sends exactly the opposite signals to LECs. At a minimum, the three-year peak usage rule should be replaced with a rule that fairly allocates jointly-used COE and OSP investment between regulated and nonregulated investments and ensures that LECs will not be penalized for making economically sound capital investments.

Summary

As described above, the regulatory safeguards that are currently in effect and will remain in place post-sunset are more than adequate to guard against predatory price squeezes, cross-subsidization, discrimination and other anti-competitive conduct.

Sincerely,

/s/ Timothy M. Boucher
/s/ Melissa E. Newman

Attachments –
Declaration of Dennis W. Carlton, Hal Sider and Allan Shampine, filed June 30, 2003 from Qwest Comments, WC Docket No. 02-112 and CC Docket No. 00-175
Reply Declaration of Dennis W. Carlton, Hal Sider and Allan Shampine, filed July 28, 2003 from Qwest Reply Comments, WC Docket No. 02-112 and CC Docket No. 00-175

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[27] In the past, LEC opponents supporting continued use of the three-year peak usage forecast rule have argued that eliminating the rule would adversely impact regulated rates. While there was no factual support for this claim in the past under rate-of-return regulation (since only a small portion of LECs' COE and OSP investment was ever assigned using the three-year peak usage rule), allocations under this rule in a price cap environment would have no affect on rates. As such, regulated rates would be unaffected if the rule is eliminated.

ATTACHMENTS

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	)	WC Docket No. 02-112
	)	
	)	
2000 Biennial Regulatory Review Separate Affiliate Requirements of Section 64.1903 of the Commission's Rules	)	CC Docket No. 00-175
	)	
	)	

QWEST COMMENTS

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QWEST SERVICES CORPORATION

June 30, 2003

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C.

In the Matter of	)	
	)	
Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements	)	**WC Docket No. 02-112**
	)	
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DECLARATION OF
DENNIS W. CARLTON, HAL SIDER AND ALLAN SHAMPINE

June 30, 2003

I. QUALIFICATIONS

1. I, Dennis W. Carlton, am Professor of Economics at the Graduate School of Business of The University of Chicago. I have served on the faculties of the Law School and the Department of Economics at The University of Chicago and the Department of Economics at the Massachusetts Institute of Technology. I specialize in the economics of industrial organization, which is the study of individual markets and includes the study of antitrust and regulatory issues. I am co-author of Modern Industrial Organization, a leading textbook in the field of industrial organization, and I also have published numerous articles in academic journals and books. In addition, I am Co-Editor of the Journal of Law and Economics, a leading journal that publishes research applying economic analysis to industrial organization and legal matters. In addition to my academic experience, I am a consultant to Lexecon Inc., an economics consulting firm that specializes in the application of economic analysis to legal and regulatory issues.

2. I, Hal S. Sider, am a Senior Economist and Senior Vice-President of Lexecon Inc. I received a B.A. in Economics from the University of Illinois in 1976 and a Ph.D. in Economics from the University of Wisconsin (Madison) in 1980. I have been with Lexecon since 1985, having previously worked in several government positions. I specialize in applied microeconomic analysis and have performed a wide variety of economic and econometric studies relating to industrial organization, antitrust and merger analysis. I have published a number of articles in professional economics journals on a variety of economic topics and have testified as an economic expert on matters relating to industrial organization, antitrust, labor economics and damages. In addition, I have directed several studies of competition in telecommunications industries and have previously testified as an expert on telecommunications matters before the FCC and various state public utility commissions.

3. I, Allan L. Shampine, am an Economist at Lexecon Inc. I received a B.S. in *Economics and Systems Analysis summa cum laude from Southern Methodist University in* 1991 and a Ph.D. in Economics from the University of Chicago in 1996. I have been with Lexecon since 1996 and have performed a wide variety of economic studies relating to telecommunications and other industries. I have published a number of articles in professional economics journals on issues relating to telecommunications and technology. I am also editor of Down to the Wire: Studies in the Diffusion and Regulation of Telecommunications Technologies (Nova Press, 2003), which addresses from an economic perspective the regulation of new telecommunications technologies. In addition, I have previously testified as an expert on telecommunications matters before the FCC.

II. INTRODUCTION AND SUMMARY

A. BACKGROUND

4. We have been asked by counsel for SBC, Verizon and Qwest to address certain issues raised in the Further Notice of Proposed Rulemaking (FNPRM) in these matters. In this notice, the FCC seeks comments on the "need for dominant carrier regulation of BOCs' in-region, interstate and international interexchange telecommunications services after sunset of the Commission's section 272 structural and related requirements in a state."[1] We address this issue below, along with the related question of whether the regulatory status of the long-distance operations of independent incumbent local exchange carriers (other than BOCs) should hinge on whether those operations are provided through a structurally separate affiliate. We use the term incumbent local exchange carriers or "ILECs" to refer collectively to the BOCs and independent LECs.

1. FNPRM, ¶2.

5. Section 272 of the Telecommunications Act of 1996 requires BOCs provide long distance services through a separate subsidiary for the first three years following approval to provide such services.[2] Although this provision does not apply to independent local exchange carriers, Commission rules require such carriers to adhere to less strict separation requirements in order to avoid dominant carrier regulation of their long distance services. In the absence of structural separation rules, ILECs would be free to more fully integrate their provision of long distance and other services.[3]

6. The FCC's FNPRM asks for comments regarding whether the FCC should impose "dominant carrier" regulation on BOCs' provision of long distance services following expiration of separate subsidiary requirements under Section 272. We understand that, if applied to the BOCs and other ILECs, these regulations: (i) could require those LECs to file tariffs, possibly with detailed cost data; (ii) may subject their ILECs' long distance services to price cap regulation; and (iii) would require them to comply with restrictions on market exit.[4]

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2. As explained in the FCC's initial notice in this proceeding, BOCs and their long distance subsidiaries: (i) may not jointly own transmission and switching equipment; (ii) may not share employees or real estate; (iii) may not perform any operating, installation, or maintenance functions for each other; and (iv) must maintain separate books of account; (v) must have separate officers and directors; and (vi) must conduct all transactions on an arm's length basis.) FCC, NPRM in the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket NO. 02-112, FCC 02-148, May 24, 2002, 4-5.
3. Both SBC and Verizon have estimated that expiration of separate subsidiary rules would result in large savings over coming years. Verizon estimates that it could save "almost $247 million through 2006 if the separate affiliate restrictions were eliminated today..." Comments of Verizon in the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112, August 5, 2002, pp. 10-11. SBC estimates that it could save "50 percent for personnel in the network engineering, customer care, billing and network operations departments" as well as large additional savings in labor costs. Comments of SBC Communications Inc. in the Matter of Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112, August 8, 2002, pp. 7-8.
4. FNPRM, ¶37.

7. *In the FNPRM, the FCC notes that "dominant carrier regulation should be* imposed on a carrier only if it could unilaterally raise price and sustain prices above the competitive level and thereby exercise market power by restricting its output or by its control of an essential input."[5] Based on this perspective, the FCC requests comments on the current scope of competition in the provision of long distance service as well as comments on whether expiration of separation requirements enables ILECs to harm competition by manipulating rivals' access to the local network. More specifically, the FCC asks whether expiration of structural separation rules would:

- facilitate non-price discrimination by ILECs against their long distance rivals;
- enable ILECs to engage in a "price squeeze" designed to drive their long distance rivals from the market;
- enable ILECs to harm competition by shifting costs from their long distance to local service operations.

B. SUMMARY OF CONCLUSIONS

8. We conclude that permitting the BOCs and independent ILECs to integrate their long-distance and local exchange operations will not adversely affect competition.[6] Thus, there is no economic basis for imposing dominant carrier regulation on BOCs' in-region long distance service based on the sunset of Section 272 structural separation requirements, nor is there any economic basis for conditioning the non-dominant status of independent LECs' long distance operations on the structural separation of those operations.

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5. FNPRM, ¶5.
6. As noted above, separation requirements faced by non-BOC ILECs are less restrictive than those faced by BOCs. Our conclusion that expiration of the BOC rules would not adversely affect consumers necessarily implies that expiration of the less stringent rules faced by non-BOC ILECs also would not result in consumer harm.

9. *First, competition in the provision of long distance services has increased* dramatically since 1995 when the FCC determined that AT&T should not be subject to dominant carrier regulation.[7] As discussed in more detail in Section III below, competition along each of the dimensions considered by the FCC has increased:

- The share of wireline subscribers served today by ILEC long distance services (in areas in which they are authorized to provide them) is far smaller today than AT&T's share in 1995, when the FCC concluded that it was not a dominant carrier. More generally, the concentration of wireline long distance services has fallen dramatically since 1995.
- Consumers are increasingly using alternative technologies for long distance communications. Since 1995, wireless services have come to account for a substantial and growing fraction of long distance calls. There also has been tremendous growth in e-mail and instant messaging, which are substitutes for certain long distance calls. Emerging technologies such as "voice over Internet Protocol" (VoIP) and continued growth of existing alternatives to wireline long distance service promise even greater future competition.
- Analysts and carriers agree that there is a glut of capacity in long distance facilities resulting from the deployment of new national fiber optic networks as well as increased capacity of network electronics, which are placing downward pressure on prices.
- Wireline long distance usage has fallen substantially over recent years, from an average of 71 minutes per month in 1995 to 41 minutes per month in 2002. As a

7. The FCC's opinion in that matter addressed the conditions under which a long distance supplier can exercise market power (in the absence of any ability to manipulate access to the local network which, as shown below, is unaffected by expiration of Section 272).

result of both declining prices and usage, average monthly household wireline long distance spending has fallen from $21.42 in 1999 to $12.39 in 2002.

10. Second, expiration of structural separation rules would not enable ILECs to adversely affect competition by manipulating access to their local network. As discussed in more detail in Section IV below:

- The expiration of structural separation rules does not adversely affect the ability of regulators to detect non-price discrimination in the provision of access services by ILECs. A number of regulatory safeguards against discrimination would remain in effect following expiration of the structural separation requirement. In addition, ILECs' rivals in the provision of long distance service include large and sophisticated companies that routinely monitor the quality of access services that they receive.
- The expiration of structural separation rules would not give ILECs the incentive or ability to harm competition by engaging in a predatory "price squeeze" designed to drive their long distance rivals from the market. It is widely recognized that successful predation is rare. It is especially unlikely that it could succeed in industries, like telecommunications, in which there are substantial fixed assets that are likely to remain in the industry even if rival long distance companies become bankrupt. The continuing presence of these assets in the industry precludes recoupment of any investment in predation. Moreover, even if an ILEC could drive and keep its competitors from the industry, it would have no assurance of being able to recoup its losses because it would likely face re-regulation of the rates it charges due to its new monopoly status. Because

recoupment is so unlikely, it is highly unlikely that any ILEC would pursue such a strategy.

- Nor would the elimination of structural separation requirements increase ILECs' incentive or ability to harm competition by engaging in cross-subsidization. The FCC raises concerns that cost shifting can (i) facilitate predation or (ii) enable ILECs to avoid regulation of local services. With respect to the former, an ILEC's incentive and ability to engage in predation does not depend on its ability to shift costs. With respect to the latter, cost shifting makes sense only if it enables the ILEC to recover these costs in the price of the regulated service. However, due to price cap regulation of local service rates and intrastate access charges as well as the FCC's CALLS order regulating interstate access charges, prices for regulated services are now set with little regard to costs. In any event, as the FCC itself has recognized, dominant carrier regulation of long distance services is designed to ensure that long distance rates are not too high and is an inappropriate tool for protecting against improper local rate increase.

11. In Section V we elaborate on this point and show that even if one were to (incorrectly) conclude that the expiration of structural separation rules raised competitive concerns, dominant carrier regulation is ill suited to address them. We also discuss how, in the absence of competitive concerns resulting from expiration of the structural separation requirements, imposition of dominant carrier rules would adversely affect competition in the provision of long distance services by discouraging competition and development of new services.

III. *THE INDUSTRY HAS BECOME MUCH MORE COMPETITIVE THAN IN 1995,* WHEN THE COMMISSION DETERMINED THAT AT&T WAS NOT A DOMINANT FIRM

12. The FNPRM requests comments on the current scope of competition in the provision of long distance service and asks whether the lifting of structural separation requirements risks harm to competition that requires imposition of dominant carrier regulation. This section shows that, using the FCC's framework for evaluating competition in long distance services (in the absence of concerns about manipulation of access to the local network), there is no basis for subjecting ILECs to dominant carrier regulation.

13. The FCC concluded in 1995 that AT&T's long distance service should not be subject to dominant carrier regulation.[8] Because AT&T did not provide local exchange services, the FCC's review at the time focused exclusively on conditions in the long distance marketplace. We maintain the same approach in this section. As noted above, however, the FNPRM also raises concerns that expiration of the separate subsidiary requirements would give ILECs the incentive or ability to raise long distance prices by manipulating access to their local network through non-price discrimination, executing a predatory price squeeze or engaging in cost shifting. Section IV below shows that there is no basis for these concerns.

A. FRAMEWORK FOR EVALUATING ILECS' DOMINANCE AS LONG DISTANCE SERVICE PROVIDERS

14. The exercise of defining economic markets is undertaken in order to determine the forces that determine price and to determine whether firms can exercise market power. A properly defined market includes all firms whose participation in provision of a service significantly constrains the price under analysis.[9]

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8. FCC, Order in the Matter of Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, FCC 95-427, 11 FCC Rcd 3271, October 23, 1995 (hereafter, "AT&T Non-Dominance Order").
9. According to Carlton and Perloff, Modern Industrial Organization, 3rd edition, "[a] firm (or group of firms acting together) has market power if it is profitably able to charge a price

15. The FNPRM states that rapid changes in the telecommunications industry in recent years have blurred traditional distinctions between wireline and wireless services and between local and long distance services. These changes complicate the delineation of a precise market definition. However, it is not necessary to precisely delineate the current scope of the product market to address the question posed in the FNPRM – whether ILECs should be subject to dominant carrier regulation following expiration of structural separation requirements. This is because, compared to 1995 – when the FCC determined that AT&T was not dominant – the industry has become much more competitive, regardless of the precise market definition used. Therefore there are no changes in competitive conditions that justify imposition of dominant carrier regulation.

16. In the 1995 AT&T Non-Dominance proceedings, the FCC addressed the conditions under which a long distance carrier should be subject to dominant carrier regulation.[10] The Commission's analysis focused on four factors: (1) market share; (2) demand elasticity; (3) supply elasticity; and (4) disparities in size, resources, financial strength and cost structures

(...continued)
above that which would prevail under competition, which is usually taken to be marginal cost." (p. 610.) A market is defined to include "all those products that are close demand or supply substitutes." (p. 612) The Merger Guidelines of the U.S. Department of Justice and Federal Trade Commission define two services as being in the same market if a small, but non-transitory price increase by a monopoly provider of one of these services would cause enough buyers to shift their purchases to the other service so as to render the price increase unprofitable. U.S. Department of Justice and the Federal Trade Commission, Horizontal Merger Guidelines, Revised April 8, 1997, Section 1.11. The FCC relies on the same basic framework and specifically applies the Merger Guidelines approach in FCC, Opinion in the Matter of Regulatory Treatment of LEC Provision of Interexchange Services Originating in the LEC's Local Exchange Area and Policy and Rules Concerning the Interstate, Interchange Marketplace, 12 FCC RCD 15, 756 (hereafter, "LEC Non-Dominance Order"), ¶25.

10. The FCC's analysis did not address the effect on long distance prices of a long distance carrier's ability to manipulate access to the local network, since AT&T did not provide local exchange services.

among the market participants.[11] At that time the FCC highlighted the fact that:

- AT&T's share of subscribers and revenue had rapidly declined in prior years;
- There was significant excess capacity in the long distance industry and competitors could readily expand.[12]
- AT&T's customers readily switched long distance carriers.[13]
- AT&T's large size, financial strength and technical capabilities were not sufficiently unique to confer market power.[14]

17. In this section we review the current state of competition in the long distance industry using the same general framework and show that, along each dimension, the industry has become much more competitive than in 1995, when the Commission determined that AT&T was not a dominant firm.

B. RECENT CHANGES HAVE BROUGHT INCREASING COMPETITION TO THE LONG DISTANCE INDUSTRY

18. Along each of the dimensions analyzed by the FCC in the AT&T Non-Dominance proceeding, the long distance industry today faces considerably more competition than in 1995.

- The industry faces increased competition from new wireline service providers, principally BOCs. Although the BOC entry has heightened competition in the provision of long distance services, by any measure their share remains well below that of AT&T in 1995 when AT&T was declared non-dominant. Each BOC (and independent ILEC) is expected to account for less than 10 percent of wireline subscribers nationwide, even after the 271 process is complete. Each BOC's (in-region) share of wireline subscribers is expected to remain far lower

11. AT&T Non-Dominance Order, ¶38.
12. Id., ¶70.
13. Id., ¶63.
14. Id., ¶73.

than AT&T's share in 1995. Overall, industry concentration has fallen sharply and the disparity in the share of subscribers served by the major wireline long distance firms is expected to remain much smaller than in 1995.

- Wireline long distance service providers also face substantial and growing intermodal competition from wireless services. E-mail and instant messaging, which are substitutes for certain long distance calls, provide a significant additional source of competition. As a result, the volume of wireline long distance minutes has declined sharply in recent years. Under these circumstances, attempts by wireline providers to raise prices would result in the loss of minutes to wireless services, e-mail and instant messaging, even if ILECs retained their existing long distance customers.
- There has been a vast increase in industry capacity in recent years resulting from massive deployment of new fiber optic capacity as well as increases in capacity due to advances in network electronics.

19. As shown below, the long distance industry is in the midst of large-scale and fundamental changes. Such circumstances reduce the ability even of firms that account for a large share of industry output to exercise market power (as well as attempts by members of an industry to act in any coordinated fashion). In dynamic industries, firms will have varying perceptions about future demand and supply conditions and, as a result, will have strong incentives to pursue independent strategies. Under these circumstances, current market shares and concentration measures are likely to be poor indicators of a firm's future ability to exercise market power or the ability of firms in the industry to act in a coordinated fashion.